CONFIDENTIAL – Presentation Briefing

Date: September 22, 2022

Re: Real Estate Investment Advisory Council
Third Quarter Presentation: **Debt Capital Markets**
Hotel InterContinental Buckhead

On Thursday September 22nd, The Real Estate Investment Advisory Council returned with its first live presentation format since the pandemic.

Meeting at the InterContinental Hotel Buckhead, members and guests caught up on each other's previous two years, and the return to normalcy.

REIAC presented its 19th annual Debt Capital Markets outlook, a timely, informative and realistic look at the downturn of the US economy, the volatility of the capital markets, and the impact on commercial real estate.

The REIAC audience was treated to the high-level expertise and experience of:

Michael Thomas, EVP and Head of PNC Real Estate
Jack Gay, Global Head of Commercial Real Estate Debt for Nuveen Real Estate
Lea Overby, Managing Director and Head of CMBS Research at Barclays Capital
Leland Bunch III, Managing Director, Real Estate Structured Finance, Bank of America
Elaine McKay, Managing Director and Co-head of US Investment Operations at Ares Real Estate, and
Brian Olasov, moderator and Adjunct Professor of Real Estate Capital Markets, New York University

Moderator Brian Olasov set the stage by recalling the previous day's tumultuous "news of the day" over a five-hour period:

- The Ukraine War discussions in the United Nations regarding nuclear war;
- Seven CEOs testifying before Congress;
- The New York City Attorney General explaining how real estate should be valued; and
- Jay Powell increasing rates by another 75 basis points, and indicating that once the government gets to a terminal rate of 4.4% it will stay there a while (we're currently at 3.2%).

Bottom line, says Brian, "There is no relief coming soon."

On top of that, no one really knows what is going to happen next. Even the research folks can't explain the 20 basis point movement in the 10-year treasury in one day.

The capital markets have seen and handled such turmoil before, and this time the causes are

- Climate change
- Major geopolitical events
- Work from home that impacts office
- On-line shopping that impacts retail
- Decline in the GDP that impacts everything.

New to the mix, however, are the rate hikes, which are soaking up all the extra cash that could have addressed and worked to help solve the above problems.

The Big (rate hike) Chill

These are large interest rate changes in a short amount of time, especially on a relative basis. An example: An asset that has a debt service coverage ratio of 3.0x would now be halved to 1.4x. If the asset was producing a net cash flow of $3 million, it drops to $1 million. On top of that, interest rate caps will be very expensive to replace when they expire.

The lenders agree that every deal they are seeing and closing right now is negative leverage. Cap rates have not adjusted as fast as interest rates. But lenders are willing to move forward with borrower's optimism as long as upward rent trends are supportable for the next year out so as to achieve neutral leverage beginning in month 13 of the loan term.

Lending on transitional properties brings up the concern of believing in future rent growth. While a year ago it was easy to say that NOI will increase, how easy is it to believe in double-digit rent growth for a three or four year period? That is what it would take in many cases to be able to refinance out of a bridge loan made today at these increasing interest rates. Such business plans are getting less believable.

So, across the board, lenders are leaning into the safer bets: industrial and multifamily. Especially industrial with its very tight vacancy rates.

Lenders rely on appraisals as part of the due diligence process, but valuing a property is difficult in such a volatile time. Since lenders don't think that rents will continue to increase endlessly, most lenders size loans based on in-place NOI only. The dilemma there is that such analysis might make some lenders uncompetitive.

Is there such a thing as Affordable?

On the housing front, the near-term rent spikes in multifamily are making housing less affordable. How does one really address affordability? The Fed can't affect multifamily rent spikes, but it can lower the price of homes by raising interest rates, which impacts housing prices downward. So now there is less housing

turnover, as current homeowners do not want to trade up in housing size, thus creating more available entry-level housing.

What was a 2.89% 30-year mortgage a year ago is now 6.40%, which on average adds about $700 to the monthly payment. Fundamentally this supports multifamily as the only residential option, even with its rent spikes. Bottom line: politics are always the wrong answer to an economic problem.

The Fed and government do not ask “what really happened in the last economic downturn” but instead simply focus on “let’s not have another GFC.”

After COVID set in, multifamily rents spiked. So where did all these people come from? From crowded cities where people share small apartment units. COVID meant we all wanted more space, without roommates, and where there are places to go outside to enjoy the environment. That’s why New York City emptied out to the suburbs, or to the Sunbelt. And with more money in everyone’s pocket from the $6 trillion that the government pumped into the economy, people could afford to move, to pay higher rents.

So, are we in a recession? It seems like an oxymoron right now; declining GDP, but unemployment at 3.7% and wages increasing everywhere. Government solutions lag the real economy, so in the short term, no, we are not in a recession.

The Greater Fool Take-out Lender theory

Six months ago, when it was still frothy out there, a lot of full leverage loans were made at the peak of asset pricing. Now, who is likely to get burned? The lender panel agreed that the smaller community banks will be the ones taking the hit.

Community banks don’t go through the same level of scrutiny of their loans, might not have the same access to analysis and research, and might have differing reasons for making riskier loans, i.e., for the good of their local community.

The OCC and the FDIC are flashing red regarding commercial real estate lending. While they haven’t prohibited real estate lending, banks are getting the message and are slowing down.

Some panelists believe the retreat is unwarranted; this opposing view says that lending in this cycle has been conservative compared to the previous cycle and our economy is in good shape. There has not been nearly as much condo construction lending, and banks have more reserves this time around, ratios of 11% vs. the 3% prior to the GFC.

Nonetheless, it’s not real estate lending that will cause the recession, it’s all that free money thrown into the economy.

Is real estate a good hedge against inflation?

For floating rate lenders, the answer is an obvious yes. Rising interest rates are immediately reflected in the adjustable debt service payments.

Assets like multifamily are the best hedges against inflation, since the leases are re-priced annually. Certainly, property supply and demand needs to be in balance. Office assets are not in a supply/demand equilibrium, and landlords cannot pass along expense increases with so much space coming back on the market. And credit leases are usually five or ten years in term, so there's no opportunity to move rents any time soon.

Speaking of office space, research suggests the national office usage will decline by another 15%, which will translate to a 40% decline in asset value. This varies across the country, and even within a large market. For example, New York City occupancy will decline according to which neighborhood it is in, with those near commuter rail lines performing better.

Office landlords in New York are now working through improvements to get the young professionals to come back into the city. Amenities such as "entertainment floors," genius bars and basketball courts are in the mix. Clearly, tenants have all the power. Even class A buildings need to improve the amenities, as being class A isn't enough.

For class B buildings, the adaptive re-use business plan gets a lukewarm response at best. "Well, we'll at least listen to your plan" says one panelist.

But class B adaptive re-use is a hair better than regional mall conversions, which got a solid "no-go" from the panel.

The preceding Confidential Briefing is for information only and does not represent the respective opinions of REIAC, its membership or its Board of Directors.

REIAC

The Real Estate Investment Advisory Council (REIAC) was established as a nonprofit trade association to provide a forum for the exchange of ideas, concerns and experiences among senior executives who conduct commercial real estate transactions. The Southeast chapter of REIAC was founded in 1994.

REIAC is an exclusive, **principals-only** national fellowship of top real estate executives that offers superior educational events, networking opportunities and community service. REIAC's institutional quality programs are presented in a social environment where members can share experiences and knowledge with their peers. REIAC events encourage members to broaden horizons and develop personal relationships that further their success within the industry.

For further information, please contact:

Jerry Monash, President, Southeast Chapter of The Real Estate Investment Advisory Council
(404) 847-9781
jerry@lancetrealtyadvisors.com